

## **NEW DEVELOPMENTS IN IDAHO INCOME TAXATION OF TRUSTS AND ESTATES**

Recent activity has stirred the normally sedate area of Idaho income taxation of estates and trusts. We have a flurry of legislative activity and disputes between taxpayers and the Idaho State Tax Commission. The following questions and answers provide current guidance to Idaho attorneys in this important area.

**Question – In the 2009 Idaho legislative process, the ISCPA co sponsored HB 232 which “clarified” a credit on the Idaho Fiduciary Income Tax Return (Form 66) for taxes paid to other states where the income is also being reported on the Idaho Form 66. Is this something new and how does it work?**

Answer – John McGown –

The 2007 Idaho Form 66 contained a section for the computation of the credit taxes paid to other states. This section disappeared from the 2008 Form 66. Interestingly, there was no change in the law. There also was no mention of this deletion in the 2008 Instructions for Form 66. One of the members of the Idaho Society of CPAs (ISCAPAs), Roger Clubb (who has a daughter playing soccer for Timberline High School), asked Melissa Nelson (ISCPA’s Executive Director) about the deletion. Melissa followed up and learned that the Idaho State Tax Commission looked at the Idaho statute for the credit for taxes paid to other states and determined that it did not directly apply to estates and trusts.

The ISCPA took a team approach to restoring the credit for estates and trusts. Ken McClure, ISCPA’s lobbyist, Melissa and I worked with the Idaho legislature and the Idaho State Tax Commission to pass legislation to restore the historical practice of allowing the credit. The Trust and Estate Professionals of Idaho, Inc. also assisted. Senator Brent Hill and Rep. Dennis Lake were of great help, as were Dan John and Janice Boyd of the Idaho State Tax Commission. The bottom line is that House Bill 232 was passed by the 2009 Idaho Legislature and the 2009 Idaho Form 66 will have a section for the computation of the credit for taxes paid to other states.

**Question – There are some Idaho resident estates and trusts that have been getting deficiency notices from the Idaho State Tax Commission demanding the estate or trust to pay the tax for the nonresident beneficiary who has failed to do so. How does the Personal Representative or Trustee know to pay this tax for the beneficiary and are there any changes coming in this area?**

Answer – John McGown –

The concern starts with Idaho Code Section 63-3026A (also discussed in the last question). It sources all income from an Idaho resident estate or trust to Idaho even if the income is clearly not Idaho source income, such as from the sale of New Mexico real estate. This means that a Utah beneficiary of an Idaho resident estate or trust with gain from the sale of New Mexico real

estate has income from three different states—Utah (as the state of the beneficiary’s domicile), Idaho (because Idaho sources the New Mexico income to Idaho since it is from an Idaho resident estate or trust) and New Mexico (since it is from real property located in New Mexico). Utah will allow only one credit for taxes paid to other states, meaning that the Utah beneficiary has a net of two state income taxes to pay on the income from the sale of the New Mexico real estate (i.e., there are three state income taxes being asserted, with only one credit, for a net of two state income taxes on a single item of income). As discussed in the answer to the next question, several of us have raised this issue with the Idaho State Tax Commission and we are hopeful for a legislative solution in the 2010 Idaho Legislative Session. The solution would be to remove the automatic sourcing of income to Idaho from a resident Idaho estate or trust.

Idaho State Bar members need to be aware that the Idaho State Tax Commission is proposing a new form--Idaho K-1--to be used when filing 2009 Idaho returns for flow through entities.

In any case, there is a concern with the current law and out of state beneficiaries of Idaho resident estates and trusts not filing Idaho income tax returns on what the Idaho State Tax Commission is asserting as Idaho source income. Idaho Code Section 63-3022L(3) makes the estate or trust liable for the beneficiary’s “tax on such items at the rate applicable to corporations.” The estate or trust has several strong arguments available to it in these circumstances. One, Idaho’s scheme of automatically sourcing to Idaho all income from an Idaho resident estate or trust is constitutionally questionable. Two, the Personal Representative or Trustee may be able to convince the nonfiling nonresident beneficiary to file an Idaho income tax return. This is especially true if the beneficiary lives in a state which has an income tax because that state should allow a credit for the tax paid to Idaho—meaning that the beneficiary should be out of pocket only for the tax preparation fees (which the Personal Representative or Trustee may be willing to pay). Three, the statute imposes the income tax liability on the estate or trust. If the estate or trust has fully distributed, there arguably is no individual liability of the Personal Representative or Trustee. Or if the estate or trust has not fully distributed, then the Personal Representative or Trustee may be able to offset future distributions to the nonfiling nonresident beneficiary by the amount of income tax the estate or trust had to pay.

The Idaho State Tax Commission recognizes that there is a problem in going after Personal Representatives and Trustees for the Idaho income tax that out-of-state beneficiaries have failed to pay, especially when the estate or trust has been fully distributed and closed. As part of its 2010 Legislative Package, the Idaho State Tax Commission is proposing a withholding provision for pass through entities, which would allow such entities (including Idaho resident estates and trusts) to hold back part of a distribution to a beneficiary and submit the amount held back to the State Tax Commission. Whether this is an appropriate solution to the problem needs further thought. But the Idaho State Tax Commission is to be commended for putting a possible solution on the table for discussion.

**Question – Out-of-state beneficiaries of Idaho resident trusts have been getting deficiency notices from the Idaho State Tax Commission. Has there been a change in the law? The income flowing through these estates or trusts is solely comprised of interest and dividends. Why is the Idaho State Tax Commission taxing this income? Are there plans to change this?**

Answer – Mike Sullivan –

If you are the trustee of an Idaho resident trust and you have beneficiaries that reside outside Idaho, be prepared to get a call from them asking you why they just received a deficiency notice asking for Idaho income tax for years starting in 2002 forward. As a corporate trustee, we wondered if there had been a change in the law ourselves. Interestingly, Idaho Code Section 63-3026A has been in place for many years but until recently the State Tax Commission was not taking the position they now are. In 63-3026A(3)(iv), a non-resident taxpayer is to include “income from an Idaho resident trust or estate” on his or her Idaho individual income tax return. It does not clarify that the income flowing through the trust or estate to the beneficiary must be Idaho source income. Our historical understanding of Idaho source income was income from an Idaho business, farm or real estate, including the installment gain from the sale of these Idaho assets. Although the Idaho State Tax Commission is currently enforcing this automatic characterization as Idaho source income, they have been supportive in changing the law. I am not aware of any other states that don’t follow the conduit principle of retaining the character of income and deductions flowing through a trust or estate to the beneficiaries.

We are currently working on the draft legislation and hope to have it in the 2010 Idaho Legislative Session. I don’t believe the fiscal impact should jeopardize our success since this isn’t tax that Idaho has collected in the past. Stay tuned.

*Questions and Answers by John McGown, Esq. & Michael W. Sullivan, CPA/PFS. John is a practicing attorney for the Boise offices of Hawley Troxell Ennis & Hawley LLP and specializes in general tax matters, including estate and trust issues. Mike is a regional trust manager for U.S. Bank Private Client Group. Both are on the ISCPA Personal Financial Specialist (PFS) Committee, members of the Trust and Estate Professionals of Idaho (TEPI), Boise Estate Planning Council, and various other professional organizations. Both are currently working on Idaho legislation in the areas below. Both also have daughters playing soccer for Boise High School.*